

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS  
PUBLIC UTILITIES COMMISSION

IN RE: VERIZON-RHODE ISLAND'S :  
ALTERNATIVE REGULATION PLAN : DOCKET NO. 3445

REPORT AND ORDER

I. INTRODUCTION

New England Telephone ("NET") operated under traditional rate of return regulation until 1989. In 1989, the Rhode Island Public Utilities Commission ("Commission") altered NET's regulatory structure by approving a stipulation that permitted NET to have earnings sharing for a three-year period. After a comprehensive review of telecommunications in Rhode Island, the Commission approved a four year Price Regulation Trial ("PRT") in which NET was permitted certain pricing flexibility. In 1996, the Commission approved a Price Regulation Plan ("PRP") to regulate NYNEX, NET's successor. The PRP eliminated earnings sharing but implemented a service quality adjustment factor ("SQAF"). In 2000, the Commission approved a Price Regulation Successor Plan ("PRSP") for Bell Atlantic-Rhode Island ("BA-RI"), NYNEX's successor. The PRSP continued the regulatory framework of PRP but included additional commitments by the company such as: an increase in data network access funding of school and libraries, a Lifeline credit for low-income customers, a \$5 million refund to residential customers, and expansion of calling areas. According to Verizon-Rhode Island ("VZ-RI"), BA-RI's successor, the PRSP would expire on December 31, 2002 and therefore

on July 1, 2002, VZ-RI filed its proposed Alternative Regulation Plan (“ARP”) for effect January 1, 2003.

## II. VZ-RI DIRECT TESTIMONY

On July 1, 2002, VZ-RI submitted pre-filed testimony in support of its ARP by the following: Theresa L. O’Brien, VZ-RI’s Vice-President of Regulatory Affairs, Arthur D. Silvia, Director for VZ-RI, and Dr. William Taylor, an outside consultant. In her testimony, Ms. O’Brien initially stated that since the passage of the Telecommunications Act of 1996 (“Act”), there is significant competition in the Rhode Island telecommunications market through resale, unbundled network elements (“UNEs”) and through a competitor’s own facilities. She noted that there are no barriers to entry or exit, and pointed out the Cox Communications (“Cox”), a cable company, is offering telephone service in 34 out of 39 cities and towns in Rhode Island. In recognition of this new competitive marketplace, VZ-RI proposed its ARP which is a step toward full market-based price regulation.<sup>1</sup>

Ms. O’Brien summarized the ARP. She stated that the ARP allowed VZ-RI to increase primary basic residential service by no more than \$2 per month per year for the first two years of the plan after which, VZ-RI can raise the price at its discretion. She noted that changes in price for intrastate-switched access service must be revenue neutral. Also, Ms. O’Brien stated that for all other retail services or new services, VZ-RI

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<sup>1</sup> VZ-RI Ex. 2 (O’Brien’s direct testimony), pp. 4-5.

would have the discretion to set the price. However, all wholesale obligations under the Act such as the prices for UNEs, interconnection and the resale discount would be determined by the Commission as provided for under the Act.<sup>2</sup>

In addition, Ms. O'Brien discussed other aspects of the ARP. Ms. O'Brien stated that VZ-RI will increase the Lifeline credit in an amount equal to any increase in primary basic residential service. Also, the ARP includes a component for exogenous events that cannot exceed \$2.5 million annually. In addition, Ms. O'Brien noted that since 1992 VZ-RI has solely funded the schools and libraries data network access program. She suggested that funding for the program should be borne by all telecommunications carriers in the State, but in the interim VZ-RI would continue its funding of the program in an amount not to exceed \$1 million, until June 30, 2003 if the ARP is approved.<sup>3</sup>

Ms. O'Brien discussed VZ-RI's Service Quality Plan ("SQP"). Ms. O'Brien argued there is no need for a SQP because competition is sufficient to maintain service quality and noted that VZ-RI's competitors are not subject to service quality standards. Ms. O'Brien stated that if the Commission were to require a SQP it should retain the existing plan. Ms. O'Brien asserted that VZ-RI's service quality has been excellent and has improved over time. She explained that the SQP consists of eight statewide service measures and one additional measure reported on an

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<sup>2</sup> Id., pp. 5-6.

individual wire center basis covering installation, maintenance and operator services. The points assigned to each individual measure are combined to produce a monthly score. The maximum number of points per month is 42 while the minimum number of points to avoid a penalty is 28 per month. In addition, there is further monitoring in three repair/maintenance areas: Out-of-Service, Not Cleared Within 24 Hours, Missed Repair Appointments and Repair Service Answer Time. If VZ-RI receives 0 points in at least two of these three service categories for consecutive months, VZ-RI incurs a penalty. Also, Ms. O'Brien explained that under the current SQP, an increase occurred in the service quality adjustment factor of 1/12 of 0.5% for each month below 28 points. Ms. O'Brien noted that because the ARP does not include a pricing formula, the new SQP would require a penalty payment of 1/12 of .5% of total annual retail revenue for each month of the year that performance is below 28 points.<sup>4</sup>

In his pre-filed testimony, Mr. Silvia argued that since the passage of the Act, Rhode Island has developed sufficiently competitive market for telecommunications and that price cap regulation is not necessary. He noted that in November 2001, the Commission concluded that VZ-RI had complied with Section 271 of the Act. Mr. Silvia stated that in the VZ-RI central offices that serve 97 percent of VZ-RI's retail lines, all three

are providing service to business and residential customers. Mr. Silvia explained that resale is a quick and attractive option for competitors because of the ease of entry, and the discount level. As for the UNE mode of entry, Mr. Silvia noted that competitive local exchange carriers ("CLECs") have UNE-Platform ("UNE-P") arrangements in every central office and as of February 2002 the use of UNE-P facilities had grown to nearly 4,800 circuits. In the facilities mode of entry, Mr. Silvia noted that CLECs have deployed at least 7 switches and Cox provides telephone services and Internet access through its cable network. Also, he stated that CLECs with facilities had over 106,000 E-911 listings as of February 2002 and that most CLECs service their customer through the facilities based mode of entry.<sup>5</sup>

In addition, Mr. Silvia asserted that the intraLATA toll market has been competitive for many years and VZ-RI estimated that 40 percent of customers currently use a wireline carrier other than VZ-RI for intraLATA toll calling. Also, he stated that wireless carriers were serving over 400,000 subscribers in Rhode Island as of June 2001. As of February 2002, Mr. Silvia stated that competitors were serving almost 135,000 lines an increase of 29,000 lines since May/June 2001, which represents an annual growth rate of 36% in competitor lines while during the same period VZ-RI's total retail access lines decreased by an annual rate of 7%. Mr. Silvia maintained that competitors are serving over 31%

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<sup>4</sup> Id., pp. 10-13.

of the business access lines in the state. Also, he asserted that six years after the passage of the Act, competitors serve nearly 19 percent of the lines in Rhode Island. Consequently, Mr. Silvia argued that price cap regulation should be abandoned in favor of granting more pricing flexibility for VZ-RI.<sup>6</sup>

In his pre-filed testimony, Dr. William E. Taylor commented on the ARP from an economist perspective. Dr. Taylor argued that since the passage of the Act, Rhode Island has become competitive. Therefore, he asserted that all regulatory constraints must be competitively neutral and VZ-RI should have pricing flexibility. Under the ARP, VZ-RI would still be constrained from raising prices on basic residential telephone service and if VZ-RI raised prices on other retail services, it would result in increased competition.<sup>7</sup>

In general, Dr. Taylor discussed the emergence of competition since the passage of the Act. He noted that competitors are providing packaged services of fixed and mobile services associated with voice, data and video thereby reducing the advantage of incumbency in all markets. In particular, Dr. Taylor emphasized the presence of facilities based competition, widely considered the most potent form of competition, in local telephone service and in particular discussed the emergence of Cox,

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<sup>5</sup> VZ-RI Ex. 3 (Silvia's direct testimony), pp. 2-7.

<sup>6</sup> *Id.*, pp. 7-11.

<sup>7</sup> VZ-RI Ex. 4 (Taylor's direct testimony), pp. 3-4.

the cable provider, and wireless competitors in the local telecommunications market.<sup>8</sup>

Dr. Taylor explained that effective competition means a sufficient level of competition to prevent an individual from profitably holding the market price above the competitive price. A firm can exercise market power if it can profitably hold the market price above the competitive level. Dr. Taylor argued that a formal market power study is unnecessary, impractical and could not be completed in a timely manner. Instead, Dr. Taylor utilized standard economic theory which demonstrates the interdependence of market share, supply and demand elasticities to determine market power. Dr. Taylor noted that the supply elasticity can be measured by the extent there are barriers to entry and expansion. Also, Dr. Taylor argued that market share alone can be misleading. Dr. Taylor noted that there are no substantial barriers to entry or expansion and there is competition for business and residential services.<sup>9</sup>

In addition, Dr. Taylor argued that the incumbent and competitors should have symmetric regulation and that competition should function as the price control mechanism. Dr. Taylor argued that pricing flexibility for VZ-RI is necessary for competition because the incumbent should be able to respond to competitors, who focus on high margin customers. According to Dr. Taylor, VZ-RI's ARP will protect residential ratepayers

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<sup>8</sup> Id., pp. 4-9.

with a \$2 per month per year cap. He argued that if VZ-RI raised prices, either customers would switch to an existing competitor or a new competitor would enter the market and the customer could switch from VZ-RI. Dr. Taylor stated that the lack of actual competitors is irrelevant because if prices increase a new competitor can easily enter the market with little sunk costs because of the availability of resale and UNEs. Also, Dr. Taylor maintained that competition will likely produce lower prices than the current price cap formula.<sup>10</sup>

### III. CLEC's DIRECT TESTIMONY

Cox Communications ("Cox") and Conversent Communications ("Conversent"), two CLECs submitted pre-filed testimony on September 20, 2002.<sup>11</sup> Cox submitted pre-filed testimony by Cindy Z. Schonhaut, an outside consultant. In her testimony, she stated that giving VZ-RI unlimited downward pricing flexibility could result in predatory pricing, which occurs when a firm has market power such that it can decrease prices below actual costs so as to cause competitors to exit the market and prevent new competitors from entering the market. Ms. Schonhaut defined actual costs as UNE prices produced by the total elemental long run incremental cost ("TELRIC") methodology. In addition, she argued that pricing below TELRIC would result in a price squeeze for CLECs utilizing UNEs. Ms. Schonhaut conceded that resale would survive

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<sup>9</sup> Id., pp. 9-12.

<sup>10</sup> Id., pp. 12-22.

<sup>11</sup> There were no objections to Cox and Conversent's motions to intervene.



predatory pricing, but the other modes of entry envisioned by the Act would be eliminated.<sup>12</sup> In addition, Ms. Schonhaut suggested that the Commission request that interested parties submit proposals for the appropriate imputation standard and enforcement mechanism for a price floor. Also, she requested that the Commission maintain current pricing regulations for intrastate access services because VZ-RI could manipulate the pricing of different elements within intrastate access service offerings to the detriment of competitors.<sup>13</sup>

Ms. Schonhaut noted that due to the instability and uncertainty in the telecommunications industry VZ-RI should continue under the PRSP until the industry stabilizes.<sup>14</sup> In the alternative, she recommended a three year initial period within which VZ-RI's pricing flexibility for residential customers would remain limited, and for one year, continue the current price regulation for business services. Ms. Schonhaut elaborated by stating that residential rates could be increased by \$2.00 per month per year for the first three years after which, these rates would be subject to both a ceiling, and a floor that is TELRIC based. In regards to business rates, Ms. Schonhaut stated that in the first year these rates would remain under price regulation but afterwards would be subject to a ceiling and floor.<sup>15</sup> Also, Ms. Schonhaut recommended that

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<sup>12</sup> Cox Ex. 1 (Schonhaut's direct testimony), pp. 15-16.

<sup>13</sup> Id., pp. 17-19.

<sup>14</sup> Id., pp. 19-28.

<sup>15</sup> Id., pp. 28-33.

the issue of funding Internet access for Rhode Island schools and libraries be referred to another proceeding.<sup>16</sup>

Conversent submitted pre-filed testimony by Dr. August H. Ankum. In his testimony, Dr. Ankum stated that in the section 271 proceeding, the issue was whether VZ-RI had complied with the Act by irreversibly opening its local market to competition, but in this proceeding, the issue is whether the level of competition is sufficient to curtail VZ-RI's market power. In addition, Dr. Ankum noted that in order to defeat competition, VZ-RI could increase retail rates to earn high profits at the expense of ratepayers not subject to competition, while at the same time, decreasing retail rates below a price floor in services and regions where VZ-RI faces competition.<sup>17</sup> Dr. Ankum argued that VZ-RI's proposal to establish price caps on certain residential services is an acknowledgment that there is not sufficient competition for such services. Also, he stated that in Rhode Island, UNE-P is not economically viable and VZ-RI is not relieving this problem but is instead proposing to increase UNE rates. Furthermore, he questioned VZ-RI's E-911 data in determining CLEC market share because the E-911 data is proprietary and cannot be validated by intervenors. In addition, he stated that VZ-RI's ARP would allow VZ-RI to price business services on a per customer and per location basis so as to target and harm CLECs.<sup>18</sup>

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<sup>16</sup> Id., pp. 33-34.

<sup>17</sup> Conversent Ex. 3 (Ankum's direct testimony), pp. 9-10.

<sup>18</sup> Id., pp. 11-14.

Dr. Ankum stated that the most vulnerable CLECs are carriers, like Conversent, that use UNEs. If VZ-RI were to lower its retail prices below the UNE rates it charged to CLECs, these CLECs could no longer compete profitably. According to Dr. Ankum, this strategy is known as a “price squeeze.” A price squeeze occurs when a vertically integrated firm such as VZ-RI competes against companies such as CLECs in retail markets, while at the same time, controlling prices in wholesale markets for critical inputs, such as UNEs, that its competitors depend upon.<sup>19</sup>

Dr. Ankum emphasized that if VZ-RI has unlimited downward retail pricing flexibility it could selectively target CLEC customers because VZ-RI knows the general location and nature of the CLECs’ customers. A CLEC could not match VZ-RI in short-run marginal cost pricing because VZ-RI has a larger rate base and network. According to Dr. Ankum, CLECs would retreat from wire centers, lose their sunk costs in collocation spaces and be deterred from committing to new investments in Rhode Island. Also, Dr. Ankum noted that short run marginal pricing will only decrease prices temporarily because VZ-RI would raise prices once the CLEC competition ceases to exist.<sup>20</sup>

Next, Dr. Ankum discussed the modifications made to VZ’s ARP in New York. He cited the requirement of a price floor equal to VZ’s incremental costs and an imputation test, the creation of task forces on various issues important to CLECs, a \$35 non-recurring charge for a

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<sup>19</sup> Id., pp. 14-17.

UNE hot cut, and an agreement from VZ not to challenge the New York Public Service Commission (“NYPSC”) UNE rate decision.<sup>21</sup> Dr. Ankum made the following recommended modifications to VZ-RI’s ARP: a prohibition on discrimination among similarly situated retail customers so as to prevent VZ-RI from targeting just CLEC customers; a \$35 non-recurring charge for a hot cut; a commitment from VZ-RI to continue to offer the set of UNEs it is currently offering; a commitment from VZ-RI to introduce in Rhode Island the outcome of the NYPSC task force regarding competition; and a price floor imputing the TELRIC prices of all UNEs used to provide the service and a proxy for retail costs based on the approved percentage for the resale discount. In addition, Dr. Ankum argued that VZ-RI’s request for pricing flexibility is premature because the TELRIC proceeding is not completed. Therefore VZ-RI should commit to the rebuttable presumption that updated UNE prices will be lower and that the terms and conditions for UNEs and interconnection services in New York are presumptively just and reasonable in Rhode Island.<sup>22</sup>

Furthermore, Dr. Ankum discussed the 88% decline in market capitalization for CLECs and interexchange carriers (“IXCs”) from 1999 to 2002 as compared to the 44% decline for VZ. Dr. Ankum concluded that

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<sup>20</sup> Id., pp. 17-22.

<sup>21</sup> Id., pp. 20-27.

<sup>22</sup> Id., pp. 28-32.

in light of the vulnerability of the CLEC industry, his proposed modifications to VZ-RI's ARP should be adopted.<sup>23</sup>

#### IV. DIVISION DIRECT TESTIMONY

On September 25, 2002, the Division of Public Utilities and Carriers ("Division") submitted pre-filed testimony by Thomas Weiss, an outside consultant, and James Lanni, the Associate Administrator for Operations and Consumer Affairs. In his testimony, Mr. Weiss stated that the general form of VZ-RI's APR is appropriate because of the level of competition, especially for business services, in Rhode Island. He agreed with various provisions of the ARP.<sup>24</sup> However, Mr. Weiss stated that the ARP should be effective for a three-year period so as to better assess the effects of the ARP on ratepayers and CLECs. Also, Mr. Weiss opposed VZ-RI's proposal to increase primary basic residential service by \$2.00 per month for two years because it could mean an increase in the range of 11.6 percent to 16.2 percent per primary line. According to Mr. Weiss, such a large increase would hinder the objective of "universal basic residential access" in Rhode Island. According to the Division, this obligation remains with VZ-RI "since competition for residential end-user access has yet to develop adequately". In the alternative, Mr. Weiss recommended that only a 50 cent per month per year increase should be allowed for primary basic residential service and a 25 cent per month per

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<sup>23</sup> Id., pp. 33-38.

<sup>24</sup> Division Ex. 1 (Weiss' direct testimony), pp. 5-10.

year increase should be allowed for measured rate primary basic residential service.<sup>25</sup>

In addition, Mr. Weiss concurred with VZ-RI regarding its ability to have total pricing flexibility for secondary residential lines and to grant VZ-RI the ability to alter intrastate access rates as long as the effect to intrastate access revenue is neutral. Also, Mr. Weiss supported the adoption of a price floor based on VZ-RI's long run incremental cost ("LRIC") to prevent anti-competitive pricing. According to Mr. Weiss, VZ-RI must either "directly apprise the Commission of its LRIC" or "certify" that its proposed prices are not below LRIC. In addition, he stated that CLECs "should have the right of petitioning the Commission" if the price produces an anti-competitive result and VZ-RI would "have the burden to prove that the proposed prices exceed the appropriate LRIC". As for ancillary services, Mr. Weiss indicated that the Commission should adopt pricing policies that will advance competition while at the same time protecting the universal availability of telephone service to residential customers. He noted that most ancillary services are consumed at the customer's sole discretion but for some services VZ-RI "maintains significant market control". Consequently, Mr. Weiss recommended a ceiling on price increases of fifteen percent annually for these ancillary services.<sup>26</sup>

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<sup>25</sup> Id., pp. 10-12.

<sup>26</sup> Id., pp. 12-15.

In the area of exogenous events, Mr. Weiss noted that under price cap regulation, VZ-RI has only claimed two exogenous events: reductions relating to the state gross receipts tax and a reduction in intrastate costs due to a change in the FCC's jurisdictional cost allocation procedures. Mr. Weiss argued that granting VZ-RI increased pricing flexibility reduces the need for VZ-RI to receive protection from exogenous events. Consequently, Mr. Weiss recommended that the existing \$2.5 million annual cap on revenue increases for exogenous events be maintained but VZ-RI be required to absorb the first \$2.0 million. As for funding for internet access by schools and libraries, Mr. Weiss noted that VZ-RI is still the dominant carrier, especially for services with "inelastic demand relative to price," such as residential services. He argued that funding for internet access should continue through December 31, 2005 as part of the approval of any ARP. Lastly, Mr. Weiss stated service quality standards must be a component of the ARP.<sup>27</sup>

In his pre-filed testimony, Mr. Lanni described VZ-RI's current SQP which consists of Service Quality Standards, a Service Quality Index ("SQI") and a Customer Survey. In monthly reports, VZ-RI indicates statewide service performance in installations, maintenance, operator services and customer troubles per 100 lines that are reported on an individual wire center basis. Each standard consists of two quality performance levels: Surveillance and Action. Also, Mr. Lanni explained

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<sup>27</sup> Id., pp. 15-21.

that the monthly SQI consists of a point system that has 8 statewide service items and 10 Customer Trouble Reports per 100 lines from groups of ten alternating wire centers. In addition, Mr. Lanni discussed that each month, each of these 18 items are compared to the Surveillance and Action levels, and if the performance level is better than the Surveillance Level, it is assigned full credit, which is either 2 or 4 points. If the performance level is between Surveillance and Action levels, it is assigned a partial credit of 1 or 2 points. If the performance level is below Action level, it is assigned 0 points. For each month, the maximum value of the SQI is 42 and the passing monthly score is 28, and for each of the 12 months VZ-RI fails to achieve a passing score, the Service Quality Adjustment Factor ("SQAF") is increased by .0417 percent. In addition, Mr. Lanni noted that if VZ-RI receives 0 points in at least 2 of the three repair categories (Out-of-Service, Missed Repair Appointments, and Repair Service Answer Time) then the SQAF will be increased by .0417 percent. However, the annual SQAF cannot exceed .5 percent.<sup>28</sup>

Mr. Lanni discussed the Division's proposal to tighten the standards of the SQP. The Division recommended a 10 percent reduction in Surveillance and Action Levels in the Installation, Maintenance and Customer Trouble Report service categories. Also, the Division proposed the elimination of the Customer Survey poll and the

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<sup>28</sup> Div. Ex. 3 (Lanni's direct testimony), pp. 2-4.



Maintenance Service item for Special Access. Mr. Lanni noted that the Division did accept VZ-RI's proposal to accept SQP payment obligations consisting of one-twelfth of .5 percent of VZ-RI's total annual retail revenue for each month a failure occurs in the SQP.<sup>29</sup>

## V. VZ-RI REBUTTAL TESTIMONY

On October 22, 2002, VZ-RI submitted the rebuttal testimony of Ms. O'Brien, Mr. Silvia and Dr. Taylor. In her rebuttal testimony, Ms. O'Brien disagreed with the Division's recommendation of a three-year limit on ARP. Also, she stated that VZ-RI's proposal for a \$2.00 per month per year increase would average a 6.4% per year increase for primary basic residential rates. She argued this was reasonable because basic residential rates have not increased since 1994, even with expanded local calling areas. She asserted that today's basic residential rates are similar to these rates in 1985. Furthermore, she stated that a 50-cent cap on basic residential service would be 3.2 percent and would barely keep pace with inflation. In addition, she stated that VZ-RI would increase the Lifeline credit to offset any increase in primary basic residential rates.<sup>30</sup>

As for geographic rate deaveraging, Ms. O'Brien stated that the ARP "neither proposes nor prohibits geographic variations in pricing". Also, she disagreed with a fifteen percent annual cap on other retail services because all these services are competitive to some degree. In

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<sup>29</sup> Id., pp. 4-7.

addition, she noted that any change in UNE rates, such as the hot cut non-recurring charge, should be done in Docket No. 2681. Furthermore, Ms. O'Brien reemphasized the CLEC market penetration for business services and noted that Cox has several municipalities and the Providence Place Mall as customers. Ms. O'Brien noted that there is no legal basis to require VZ-RI to fund internet access and to place this burden only on VZ-RI would not be competitively neutral. Lastly, she reiterated that an SQP is unnecessary because market forces are sufficient to maintain service quality.<sup>31</sup>

In his rebuttal testimony, Mr. Silvia disagreed with the Division's recommendation on the treatment of exogenous events. Mr. Silvia stated that during uncertain financial times with state and local budget crises, any restriction on the pass through of exogenous costs would be competitively harmful to VZ-RI. Also, Mr. Silvia argued that the level of UNE-P competition is irrelevant because of the extent of facilities-based competition in Rhode Island. In addition, he noted that the CLECs market share of Rhode Island access lines in service was 13.9 percent in residential, 33.6 percent in business, and 20.9 percent in total for all lines. Lastly, he stated that VZ-RI's E-911 data was found to be a reasonable estimate of competitive entry by facilities-based CLECs.<sup>32</sup>

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<sup>30</sup> VZ-RI Ex. 5 (O'Brien's rebuttal testimony) pp. 1-3.

<sup>31</sup> *Id.*, pp. 3-7.

<sup>32</sup> VZ-RI Ex. 6 (Silvia's rebuttal testimony), pp. 1-7.

In his rebuttal testimony, Dr. Taylor stated that a dominant carrier with a large market share would not have market power if there are no barriers to market entry. Also, Dr. Taylor indicated that successful predatory pricing is not possible because VZ-RI would not be able to permanently force CLECs out of the market. He noted that Cox is a full facilities-based CLEC and is unlikely to exit the market. Also, Dr. Taylor noted that if a UNE-based CLEC exits the market, its facilities will remain in place for other CLECs to use. Also, he stressed that the wholesale resale discount will always allow competitors to “under-price” VZ-RI. Consequently, Dr. Taylor argued that predatory pricing is rarely tried and even more rarely successful. In addition, Dr. Taylor dismissed the possibility that VZ-RI would engage in a price squeeze because as soon as VZ-RI raised its prices to recoup its losses, CLECs would regain customers. Also, he reiterated his argument that the wholesale resale discount option guarantees that a competitor can never be price squeezed because the resale option allows competitors to price below VZ-RI’s retail prices and compete profitably.<sup>33</sup>

Regarding the targeting of CLECs’ customers, Dr. Taylor argued that VZ-RI already has the pricing flexibility on a per customer and per location basis to compete for contracts with individual business customers. Also, he argued that not allowing geographic deaveraging would continue the misalignment of prices and costs that discourages

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<sup>33</sup> VZ-RI Ex. 7 (Taylor’s rebuttal testimony), pp. 3-8.

competitors from servicing high cost areas. In addition, Dr. Taylor stated that it is inappropriate for public policy to take account of the needs of any particular CLEC. As for a TELRIC-based price floor for VZ-RI's retail rates, Dr. Taylor noted that Cox has no need for such a price floor and that the existence of the wholesale resale discount option makes such a price floor unnecessary to prevent anti-competitive pricing. Also, he stated that a TELRIC-based price floor would result in higher prices because it would include the recovery of a portion of VZ-RI's shared fixed and common costs. If the Commission were to adopt a price floor, Dr. Taylor recommended that it be set so that VZ-RI's retail price "be above its own marginal cost to provide the service plus any contribution from the UNEs that competitors must purchase from Verizon in order to compete." Furthermore, Dr. Taylor argued that VZ-RI's retail price is lower or slightly above the cost it incurs to provide the basic service, while the price-to-cost margin for vertical services is high.<sup>34</sup>

As for the remaining issues, Dr. Taylor noted that VZ-RI is required to purchase carrier access out of the same tariffs as its competitors and to impute those carriers' access charges in its long distance prices. He stated that VZ-RI should not be the only carrier to provide internet funding because it is not competitively neutral. Also, he disagreed with the Division's recommendation to limit price increases for discretionary services because there is sufficient competition. In addition, Dr. Taylor

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<sup>34</sup> Id., pp. 8-14.

disagreed with the Division's recommendation regarding the treatment of exogenous events, contending that changes in a regulated firm's costs should lead to changes in its prices. As for the current financial health of CLECs, Dr. Taylor argued that CLECs are taking advantage of other CLECs in financial difficulty and that the decrease in capitalization for CLECs has occurred to many other large companies. Lastly, he argued that Rhode Island is the second most competitive state in the nation and that the shakeout among CLECs, including consolidation and acquisitions, will result in robust, viable competition.<sup>35</sup>

#### VI. CLECS SURREBUTTAL TESTIMONY

On November 7, 2002, Cox submitted the pre-filed surrebuttal testimony of Cindy Z. Schonhaut. In her surrebuttal testimony, Ms. Schonhaut argued that if VZ-RI engaged in predatory pricing, it would only need to recoup enough money to remain profitable on an overall basis instead of being capable of recouping every penny of lost profit. Also, she emphasized the danger of VZ-RI having the ability to engage in selective retail pricing because it could drive out competition in specific geographic or service markets. She stated that CLECs are financially troubled and when new CLECs acquire the assets of failed companies they do not necessarily become active in the market.<sup>36</sup>

Ms. Schonhaut noted there is uncertainty for CLECs because the Commission is also reviewing UNE rates and the FCC is reviewing its

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<sup>35</sup> Id., pp. 14-22.

unbundling policies. In regard to resale, she argued that it is a minor part of the market and as an entry strategy lacks margin and success. In regard to the ubiquity of Cox's network, she stated that Cox still needs to build out its facilities, in particular to business customers. Ms. Schonhaut reiterated that geographically deaveraged rates will result in rural customers paying more for local service than urban customers. She also restated her support of a TELRIC-based price floor for VZ-RI's retail rates. As for internet funding, she recommended that it be addressed in a separate proceeding.<sup>37</sup>

On November 8, 2002, Conversent submitted the surrebuttal testimony of Dr. Ankum. Dr. Ankum disagreed with VZ-RI's assertion that the hot cut rate should be examined in Docket No. 2681 because the cost of UNEs is germane to the ability of CLECs to compete on a retail basis with VZ-RI. He reiterated that pricing flexibility for VZ-RI is premature because the new TELRIC proceeding has not been completed. He also stated that a \$35 hot-cut charge is appropriate because VZ would not have agreed to provide hot cuts for \$35 (in New York) if the cost to do so was significantly higher.<sup>38</sup>

Dr. Ankum noted that cable companies like Cox, which primarily serve residential customers, may discontinue providing phone service,

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<sup>36</sup> Cox Ex. 2 (Schonhaut's surrebuttal testimony), pp. 2-5.

<sup>37</sup> Id., p. 5-9.

<sup>38</sup> Conversent Ex. 4 (Ankum's surrebuttal testimony), pp. 2-5.

while CLECs that purchase UNEs primarily serve business customers.<sup>39</sup> Dr. Ankum also pointed out that a price squeeze may not affect Cox as it would affect other CLECs that depend upon the purchase of unbundled loops and unbundled interoffice transport from VZ-RI. Also, Dr. Ankum contended that, if VZ-RI has no incentive or ability to carry out a successful anti-competitive pricing strategy, then VZ-RI should concur with the TELRIC price floor that the Massachusetts D.T.E. ordered.<sup>40</sup>

## VII. DIVISION'S SURREBUTTAL TESTIMONY

On November 12, 2002, the Division submitted the surrebuttal testimony of its consultant, Mr. Weiss. In his surrebuttal testimony, Mr. Weiss stated that his proposal that the ARP be for a three-year term is no more arbitrary than VZ-RI's proposal that the ARP be for a two-year term. Also, he emphasized that VZ-RI's proposal would eliminate regulation altogether after two years, while the Division's proposal will allow the parties to revisit the issue after two years. He stated that the Division's proposed allowance for a 50 cent increase per month per year for basic residential service is intended to keep pace with historical rates of inflation. Furthermore, Mr. Weiss stated that VZ-RI's \$2.00 per month per year proposed increase to basic residential service rates would be equal to a minimum increase of 11.6 percent per line and cause even non-Lifeline service customers to question whether they should continue to take telephone service. Also, Mr. Weiss stated that a 15 percent cap

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<sup>39</sup> Id., pp. 5-12.

on price increases applicable to VZ-RI's discretionary services will limit the degree of pricing uncertainty for Rhode Island residential and business customers. Mr. Weiss stated that VZ-RI should continue to fund internet access for schools and libraries in order to promote universal service. Furthermore, Mr. Weiss stated that the Division's proposed exogenous events provisions are necessary to reduce financial uncertainty for VZ-RI and disagreed with Mr. Silvia's recommendations regarding the treatment of exogenous events.<sup>41</sup>

#### VIII. EVIDENTIARY HEARINGS

After duly published notice, the Commission conducted public evidentiary hearings on the ARP from November 19 through November 22, 2002 at its offices at 89 Jefferson Boulevard in Warwick, Rhode Island. The following appearances were entered:

FOR VZ-RI:	Keefe Clemons, Esq. Alexander Moore, Esq.
FOR DIVISION:	Leo Wold, Esq. Special Assistant Attorney General
FOR ATTORNEY GENERAL: <sup>42</sup>	Paul Roberti, Esq. Assistant Attorney General
FOR CONVERSENT:	Scott Sawyer, Esq.
FOR COX:	Brian Fitzgerald, Esq.
FOR COMMISSION:	Steven Frias, Esq. Executive Counsel

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<sup>40</sup> Id., pp. 12-18.

<sup>41</sup> Div. Ex. 2 (Weiss's surrebuttal testimony), pp. 2-9.

<sup>42</sup> The Attorney General filed a motion to intervene and no objection was filed.



At the November 19, 2002 hearing, members of the Rhode Island educational community gave public comment as to the importance of continuing the funding for internet access for schools and libraries.<sup>43</sup> VZ-RI presented Ms. O'Brien, Mr. Silvia, and Dr. Taylor as a panel of witnesses. Under cross-examination by counsel for the Division, Ms. O'Brien stated that a \$2 per month per year increase in basic residential service would result in approximately \$7.6 million per year in additional revenues to VZ-RI. She also stated under VZ-RI's proposal it could double the price of residential discretionary services.<sup>44</sup> In response to a question of whether a change in UNE rates would constitute an exogenous event under the ARP, Mr. Silva indicated that there would be no need to recover the costs of providing UNEs other than through UNE rates.<sup>45</sup> Dr. Taylor asserted that full facilities-based competition is the most potent form of competition and acknowledged that, if the local competitive market was limited to just resale or UNE-P competition, the market would be defective. However, Dr. Taylor was reluctant to predict whether a market with only two full facilities-based competitors would be adequate for effective competition to exist.<sup>46</sup> Dr. Taylor acknowledged that this would be a "bad time" to start up a CLEC and that "small CLECs over the course of the next few years may find competing difficult in Rhode Island." Also, Dr. Taylor admitted that the wireline voice

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<sup>43</sup> Tr. 11/19/02, pp. 9-62.

<sup>44</sup> Id., pp. 118-119, 124-125.

<sup>45</sup> Id., pp. 134-137.

market in Rhode Island is stagnant and that VZ-RI can currently bundle products in Rhode Island.<sup>47</sup> Under further cross-examination, Mr. Silvia admitted that the information listed in VZ-RI's competitive profile has not been updated and therefore the CLECs listed in the profile may be bankrupt, no longer providing service, have few customers or may not be providing voice services.<sup>48</sup>

Under cross-examination by counsel for the Attorney General, Ms. O'Brien acknowledged that Cox is VZ-RI's biggest residential competitor and Dr. Taylor admitted that a market dominated by two facilities-based carriers does not necessarily translate into effective competition. Also, Dr. Taylor acknowledged that he had not conducted a Rhode Island-specific analysis to determine the likelihood of CLEC entry to compete against the two existing full facilities-based carriers in Rhode Island.<sup>49</sup>

Under cross-examination by counsel for Cox, Ms. O'Brien concurred that the Division could petition the Commission to reopen the docket if there was "marked change in the competitive landscape", and also indicated that VZ-RI has "no plan to geographically deaverage rates right now". Under the ARP, Ms. O'Brien explained that VZ-RI would file tariff changes and the Commission would approve them in the same manner as it now approves CLEC tariffs.<sup>50</sup> Ms. O'Brien acknowledged

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<sup>46</sup> Id., pp. 147-152, 154-155.

<sup>47</sup> Id., pp. 159, 162, 164, 167.

<sup>48</sup> Id., pp. 147-152, 154-155.

<sup>49</sup> Id., pp. 238, 242, 248.

<sup>50</sup> Id., pp. 256, 258, 260.

that some of VZ-RI's loss of wireline customers could be attributed to their migration to VZ wireless service. Also, Mr. Silva stated VZ-RI could not simply discontinue providing a price-regulated service by means of creating a competitively-priced new service that includes the price regulated service.<sup>51</sup> He agreed that VZ-RI would still be required to offer the price-regulated service as a separate service and could not discontinue it without Commission's approval.

On November 20, 2002, Mr. Weiss was presented as a witness for the Division. Mr. Weiss acknowledged that business customers have benefited the most from local telephone competition. However, with regard to the market for residential plain old telephone service ("POTS"), Mr. Weiss acknowledged the possibility that prices charged by the two main competitors could still increase.<sup>52</sup> Mr. Weiss explained that LRIC differs from TELRIC in that joint costs are not included in LRIC but only the marginal cost plus common cost is calculated. Therefore, Mr. Weiss stated that LRIC will be below TELRIC. Mr. Weiss acknowledged that if VZ-RI could price below the UNE price floor it could force CLECs out of the market. However, he contended, CLECs could reduce their expenses elsewhere to make up the difference.<sup>53</sup> Mr. Weiss admitted that a TELRIC-based price floor would be easier to establish administratively because the Commission could avoid conducting a separate LRIC cost

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<sup>51</sup> Id., pp. 268, 277-278.

<sup>52</sup> Tr. 11/20/03, pp. 41, 57.

<sup>53</sup> Id., pp. 66, 78-79.

study proceeding. He also observed that Cox could price below the other CLECs and VZ-RI if a TELRIC price floor was adopted.<sup>54</sup>

Mr. Weiss concurred that the VZ-RI's Section 271 proceedings focused on whether the telephone market was open to competition, and this docket's focus is on whether there is sufficient local competition to restrain VZ-RI from exercising market power. The Division advocated for a middle approach of price ceilings and price floors between the extremes of total price flexibility and rate of return regulation.<sup>55</sup> In this proceeding, Mr. Weiss admitted, he did not examine or determine whether there is sufficient supply elasticity, demand elasticity and CLEC market penetration to restrain VZ-RI from exercising market power. He concurred that supply elasticity means the number of market participants and that, according to a recent FCC report, there are only six CLECs in Rhode Island with more than 10,000 access lines.<sup>56</sup> Also, Mr. Weiss acknowledged the importance of examining the degree of market penetration in determining whether there is sufficient local competition in Rhode Island. He agreed that there is a significant difference in CLEC market penetration between the business and residential markets.<sup>57</sup> He also agreed that there are differences in CLEC market penetration among wire centers. He concurred that VZ-RI's proposal would allow it to deaverage rates and thereby allow VZ-RI to

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<sup>54</sup> Id., pp. 88, 95-96.

<sup>55</sup> Id. pp. 99-100, 118

<sup>56</sup> Id., pp. 103-105.

increase rates in less competitive areas while decreasing rates in more competitive areas.<sup>58</sup>

The cross-examination of VZ-RI's witnesses resumed. Under cross-examination from Conversent, Dr. Taylor acknowledged that the continued availability of UNEs, particularly unbundled loops, at incremental cost could affect competition and could present an economic barrier to entry. Dr. Taylor also noted that in Massachusetts, the two full facilities-based carriers, AT&T Broadband and RCM, serve limited geographic areas unlike Cox, which serves nearly all of Rhode Island.<sup>59</sup>

On November 21, 2002, VZ-RI's witnesses were further cross-examined. Dr. Taylor indicated that in 1995, the FCC granted AT&T pricing flexibility as a non-dominant carrier in all long distance telecommunications, at which time, AT&T had market share in the 70 percent range. For some services, prior to 1995 but after divestiture in 1984, AT&T's services were subject to price ceilings and price floors, and the FCC differentiated between business and residential services as to the degree of pricing flexibility.<sup>60</sup> Dr. Taylor stated that in determining if there is sufficient competition to restrain VZ-RI from exercising market power, the Commission should look at the actual level of competition and if the market is open to competition. He concurred that in making this

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<sup>57</sup> *Id.*, pp. 107-109.

<sup>58</sup> *Id.*, pp. 112-113, 121

<sup>59</sup> *Id.*, pp. 227, 242-243

<sup>60</sup> Tr. 11/21/02, pp. 6-9

determination, market share is one important factor.<sup>61</sup> Dr. Taylor acknowledged that there is “not a small difference” in CLEC market share between the residential and business markets. This difference, along with other factors such as universal service, could be a basis for differentiating pricing flexibility between residential and business customers. Also, he concurred that there is “not a small difference” in the amount of CLEC penetration among wire centers.<sup>62</sup> Ms. O’Brien concurred that wire centers with “not a high number” of CLEC residential market share are areas where Cox has not deployed its facilities and are rural areas. Ms. O’Brien discussed the administrative difficulties of establishing different pricing flexibility standards for categories of wire centers.<sup>63</sup> Dr. Taylor concurred that under VZ-RI’s proposal it could lower its prices in areas with significant CLEC market share while raising its prices in areas with low CLEC market share.<sup>64</sup>

Dr. Taylor asserted that VZ-RI’s proposed price floor and the Division’s price floor is the same. Dr. Taylor agreed it was a possibility that if VZ-RI’s price floor is adopted, a CLEC that utilizes UNEs may have to become a reseller or a full-facilities based carrier in order to compete.<sup>65</sup> Dr. Taylor disagreed with establishing a LRIC price floor for residential services so VZ-RI can compete with Cox, while establishing a

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<sup>61</sup> Id., pp. 14-15, 19

<sup>62</sup> Id., pp. 20-21, 23-25

<sup>63</sup> Id., pp. 27-31, 34-35

<sup>64</sup> Id., pp. 42-43.

<sup>65</sup> Id., pp. 49, 54-55.

TELRIC price floor for business services for which many UNE-based CLECs compete. Also, Dr. Taylor indicated that there is “really no difference” between a LRIC price floor and the anti-trust price floor of average variable cost. Dr. Taylor asserted that if VZ-RI “lowered a price and a competitor or anyone else thought” it was below the LRIC price floor, VZ-RI “would be obliged to present its long run incremental cost”.<sup>66</sup> Commissioner Racine expressed concern that under the Division’s proposal VZ-RI could raise certain discretionary services as much as 45 percent over three years.<sup>67</sup> Ms. O’Brien indicated that in 2001, VZ-RI had approximately a 4 percent return on equity and in 2002 it had approximately a negative 4 percent return on equity even with the inclusion of directory revenues.<sup>68</sup>

Conversent presented Dr. Ankum as a witness. Dr. Ankum pointed out that resellers are unable to exert pressure on VZ-RI’s ability to set prices because the wholesale discount charged to resellers is based on VZ-RI’s retail price. Dr. Ankum stated that TELRIC is well-defined in comparison to LRIC, and that CLECs need to pay TELRIC prices to have access to VZ-RI’s facilities. Also, Dr. Ankum argued that establishing a TELRIC price floor will incent VZ-RI not to file inflated TELRIC rates.<sup>69</sup> Dr. Ankum expressed concern over giving VZ-RI the pricing flexibility to

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<sup>66</sup> Id., pp. 57-58, 67, 69

<sup>67</sup> Id., pp. 79-81, 93

<sup>68</sup> Id., pp. 112.

<sup>69</sup> Id., pp. 146-147, 153-157.

target a CLEC's particular customers.<sup>70</sup> Dr. Ankum maintained it would be very costly for a CLEC to shift from UNEs to resale but agreed it is less costly to enter the market as a reseller than as a facilities-based CLEC that purchases UNEs.<sup>71</sup> Dr. Ankum acknowledged that New York does not have a TELRIC price floor but UNE-based competition still exists in New York.<sup>72</sup> In regard to Cox, Dr. Ankum argued that Cox's costs are not lower than VZ-RI's and therefore there is no need for VZ-RI to have a LRIC price floor to compete with Cox.<sup>73</sup>

Cox presented Ms. Schonhaut as its witness. Ms. Schonhaut asserted that Cox does not have a ubiquitous network in the business areas of Rhode Island. Although Cox is a full facilities-based CLEC, Ms. Schonahut stated that Cox needs a TELRIC price floor because it needs to purchase UNEs in areas where it lacks facilities.<sup>74</sup>

Cross-examination of VZ-RI's panel of witnesses resumed. Ms. O'Brien acknowledged that VZ-RI is Rhode Island's universal service provider and therefore, the provider of last resort for telephone customers. In addition, she concurred that under state law, the Commission could initiate a proceeding if VZ-RI's prices for residential customers were not just and reasonable.<sup>75</sup> Dr. Taylor asserted that the lack of competition for rural residential customers is due to the lack of

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<sup>70</sup> *Id.*, pp. 170-171.

<sup>71</sup> *Id.*, pp. 178-180, 182.

<sup>72</sup> *Id.*, p. 184.

<sup>73</sup> *Id.*, pp. 218-220.

<sup>74</sup> *Id.*, pp. 268, 286-287.

<sup>75</sup> *Id.*, p. 323.



profit margin and therefore, an increase in rates for these customers would create competition. However, Dr. Taylor maintained that rural residential rates are currently below costs and therefore, competition would cause these rates to rise above current levels.<sup>76</sup>

On November 22, 2002, the Division presented Mr. Lanni as its witness. Mr. Lanni explained that the Division is proposing more stringent service quality standards because over the last six years, VZ-RI service quality has greatly improved. He indicated that the Division's SQP is similar to the SQP in New York but that the Division's SQP has slightly more stringent standards.<sup>77</sup> Under questioning from the bench, Mr. Lanni acknowledged that VZ-RI has done poorly in regards to "Repair Service Answer Time," but has not paid a penalty. However, Mr. Lanni concurred that if Part B of the SQP was revised so that VZ-RI would pay a penalty if, in consecutive months, it failed in one, instead of two out of three service categories, VZ-RI would have consistently failed in one service category last year. As a result, VZ-RI would have paid a \$1.375 million service penalty. Mr. Lanni agreed that this type of penalty would incent VZ-RI to improve its service quality.<sup>78</sup> Mr. Lanni conceded that VZ-RI's service quality in the "Out-of-Service, Not Clear Within 24 hours" category has had wide performance variations. Ms. O'Brien noted that poor performance during summer months may result from VZ-RI's

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<sup>76</sup> Id., pp. 328-329.

<sup>77</sup> Tr. 11/22/02, pp. 39, 43.

<sup>78</sup> Id., pp. 45-50.

technicians taking vacations.<sup>79</sup> Mr. Lanni noted that VZ-RI is the only telephone carrier in Rhode Island subject to a SQP, and that Cox would likely be the next telephone carrier to be subject to a SQP.<sup>80</sup>

At the close of the hearing, Commissioner Racine noted the importance of maintaining internet access funding for schools and libraries until a more permanent funding mechanism is established.

#### IX. SETTLEMENT

Following the initial hearings, on December 6, 2002, a Settlement Agreement ("Settlement") entered into between VZ-RI and the Division was filed with the Commission.<sup>81</sup> The terms of the Settlement are the same as the ARP filed by VZ-RI, except for the following provisions. The term of the Settlement is three years ending December 31, 2005. VZ-RI agreed to voluntarily fund internet access for Rhode Island K-12 schools and libraries for two years, until December 31, 2004, in an amount not to exceed \$4 million. VZ-RI is allowed to raise primary residential basic exchange rates by no more than \$1.00 per month, per year over the initial two years of the ARP; and any increase in such rates for the third year of the Settlement will be subject to Commission approval. VZ-RI will continue to offer all intrastate services provided currently under tariff unless VZ-RI receives Commission permission to withdraw a service, and

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<sup>79</sup> Id., pp. 61-63, 80-81.

<sup>80</sup> Id., pp.90-91.

<sup>81</sup> The Settlement is attached as Appendix A and is hereto incorporated by reference herein. Intervenors Cox and Conversent were not included in the Settlement discussions between VZ-RI and the Division and did not support the Settlement.

VZ-RI will not alter its local calling areas without Commission approval. The retail price floor is LRIC, and upon request of the Division or Commission, VZ-RI will file the necessary documentation to confirm that a price meets the LRIC price floor. If the Commission determines that an exogenous event has occurred, such as a change in tax law, VZ-RI will be allowed to reflect the impact, positive or negative, on its costs or revenues, but VZ-RI will reduce by \$1.0 million the cumulative amount to be recovered of any positive changes in its costs or negative changes in its revenues. Generally, VZ-RI cannot recover any exogenous change in excess of \$2.5 million during any one year although an excess can be forwarded for recovery in a subsequent period. Various modifications to the SQP proposed by the Division were adopted in the Settlement. Lastly, the parties agreed that approval of the Settlement would not infringe upon the Commission's statutory obligation to protect the public against unreasonable rates in accordance with Title 39 of Rhode Island General Laws.

#### X. SETTLEMENT HEARING

On December 11, 2002, the Commission conducted a public hearing on the Settlement. VZ-RI and the Division presented Ms. O'Brien, Mr. Silva, Dr. Taylor and Mr. Weiss as a panel of witnesses. In response to concerns expressed by the bench as to how the Division's LRIC price floor would be enforced, Counsel Wold indicated that for the initial price decrease the Division will recommend suspension and

investigation of the retail price decrease filed by Verizon. Ms. O'Brien stated that the Commission along with the Division has the right to review future primary residence basic exchange rates.<sup>82</sup> Mr. Weiss indicated that Paragraph 8 of the Settlement gives the Commission "the right to review and where required modify rates to protect the public regardless of what the changes in the prices are". Also, he stated that the Commission could invoke Paragraph 8 "at any time regardless of whether competition went to a negative number." Mr. Weiss concurred that the amount of competition would be one factor for the Commission to look at in determining whether to trigger paragraph 8.<sup>83</sup> Dr. Taylor indicated that his "reading" of Paragraph 8 "is the same as Mr. Weiss" and "that the Commission can do whatever it pleases" and "doesn't need and is not bound by any particular event to trigger an opening of the plan".<sup>84</sup> In response to concerns expressed by Commissioner Gaynor about the possibility of rate discrimination under the ARP, Mr. Weiss testified that it is not "in the public interest for Verizon to treat similarly situated customers differently". Mr. Weiss stated that a higher price floor would be more advantageous for CLECs but not for ratepayers.<sup>85</sup>

Dr. Taylor indicated that wireless telephone—including Verizon wireless service—is providing competition for VZ-RI's wireline telephone service. However, Dr. Taylor noted that the quality of wireless service "is

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<sup>82</sup> Tr. 12/11/02, pp. 42, 45-46.

<sup>83</sup> Id., pp. 47-49.

<sup>84</sup> Id., p. 51.

sometimes, even for digital wireless, quality is bad”. Also, “the typical cell phone” does not provide for data transmission. Furthermore, Mr. Silva agreed that there could be dead zones in Rhode Island for obtaining service from wireless carriers.<sup>86</sup> Dr. Taylor acknowledged that in 1993, before the FCC, in regard to AT&T’s request for more pricing flexibility, he stated that “the pretense or prospect of competition” was “still insufficiently met in the offer of residential and small business interexchange services and that continued price regulation of AT&T is therefore required.” Also, Dr. Taylor indicated that AT&T’s residential market share in the early 1990s was approximately 70 percent.<sup>87</sup>

Dr. Taylor admitted that a LRIC price floor will “make it less likely” for a strictly UNE-based CLEC to compete effectively with VZ-RI. Dr. Taylor also acknowledged that “resale by itself doesn’t restrict the retail price that Verizon could charge”. Ms. O’Brien acknowledged that there are residential and business customers who do not subscribe to Cox as a cable provider. Mr. Weiss acknowledged that if a customer only had resale service as a competitive option, “the ratepayer would have to pay higher rates”. Under such a scenario, Mr. Weiss indicated that the Commission would intervene to at least prevent discrimination.<sup>88</sup> Dr.

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<sup>85</sup> Id., pp. 58, 68-69.

<sup>86</sup> Id., pp. 100-103.

<sup>87</sup> Id., pp. 105-107.

<sup>88</sup> Id., pp. 109, 114-119.

Taylor indicated that “irrespective of the plan, the Commission is still obliged by Rhode Island” to enforce the “rules against discrimination”.<sup>89</sup>

Ms. O’Brien acknowledged that discretionary residential services could be more expensive for a CLEC to create or purchase from another provider than to purchase from VZ-RI. In comparing the ARP with the PRSP, she agreed that retail services that will not be subject to a price cap under the ARP were either previously contained in Basket 1 under the PRSP, or were retail services previously contained in Basket 2 and subject to a price cap under the PRSP. Counsel Clemons acknowledged that the Commission has the authority to determine VZ-RI’s form of regulation.<sup>90</sup> Mr. Weiss construed the LRIC price floor in the Settlement as the equivalent of total service long-run incremental cost (“TSLRIC”). Mr. Weiss conceded that a LRIC price floor could push CLECs that utilize UNEs “out of the market”. He stated that a LRIC price floor “is a melding of the costs that are faced by Verizon’s competitors”. Mr. Weiss indicated that the difference between LRIC and TELRIC is approximately 10 percent.<sup>91</sup>

Counsel Clemons indicated that if a legislative change occurred that made internet funding for schools and libraries a pass-through cost to be recovered from customers, VZ-RI would not consider it to be an exogenous event. Mr. Weiss disagreed, however, indicating that it is the

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<sup>89</sup> Id., p. 120.

<sup>90</sup> Id., pp. 127-133.

<sup>91</sup> Id., pp. 142-143, 151, 172, 182.

“Division’s intention to consider” a surcharge for the internet to be a “negative...exogenous change under the terms of this plan.”<sup>92</sup> In response to the question of whether the Commission could review a change of law and look at the terms of the Settlement, Counsel Clemons conceded that the Commission has statutory authority to properly regulate utilities. He also indicated that VZ-RI had agreed to extend its internet funding to January 14, 2003.<sup>93</sup> Mr. Silvia acknowledged that VZ-RI would need to demonstrate a sufficient nexus between an exogenous event and price-capped rates in order to obtain Commission approval to pass through an exogenous event increase to price-capped services, but that such approval would not be required to pass through increases to non-capped services. Mr. Silvia agreed to provide the Commission on a periodic basis with the information contained in proprietary Table 1 and Attachment A of his testimony.<sup>94</sup> Ms. O’Brien indicated that the Settlement provides for a 10 percent tightening on four service standards and a 5 percent reduction on one service standard in the SQP.<sup>95</sup>

Mr. Weiss acknowledged that if VZ-RI increased residential rates by a dollar in one area, but did not so in another area, the difference could be construed as discrimination.<sup>96</sup> In response to questioning

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<sup>92</sup> *Id.*, pp. 197, 199.

<sup>93</sup> *Id.*, pp. 198, 200.

<sup>94</sup> *Id.*, pp. 203-204.

<sup>95</sup> *Id.*, p. 209.

<sup>96</sup> *Id.*, p. 229.

regarding Paragraph L, Mr. Silvia indicated that if there was “a huge change in the marketplace,” the Commission could “reopen” the Settlement.<sup>97</sup> Mr. Weiss acknowledged that a CLEC could file an objection to a VZ-RI tariff filing on the basis that the VZ-RI price is below the LRIC price floor. Finally, Ms. O’Brien stated that if a VZ-RI price decrease was challenged and then suspended, VZ-RI would provide a “cost filing” and “litigate” within the suspension period.<sup>98</sup>

## XI. BRIEFS

### A. VZ-RI

On January 7, 2003, VZ-RI filed its brief. At the outset, VZ-RI noted that the Commission has indicated that competition in local telecommunications market is in the public interest and should be implemented as broadly as possible and as soon as possible. VZ-RI reiterated the Commission’s finding in the Section 271 proceeding that the local telecommunications market is open to competition and there are no barriers to entry. Also, VZ-RI argued that there is substantial actual competition in Rhode Island because as of August 2002, CLECs were serving approximately 20% of all access lines (approximately 34% of business lines and approximately 14% of residential lines) and, according to the FCC, Rhode Island has the second highest level of CLEC market share in the nation. In addition, VZ-RI noted that there are 450,000

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<sup>97</sup> Id., pp. 231-34.

<sup>98</sup> Id., pp. 250-251, 261-262.



wireless subscribers in Rhode Island, but also acknowledged that these wireless services do not completely displace wireline telephones.<sup>99</sup>

VZ-RI argued that the Settlement is in the public interest. VZ-RI noted that it will provide funding for internet access to schools and libraries through December 31, 2004. Also, VZ-RI's ability to increase primary basic residential rates by \$1 per month, per year is reasonable since VZ-RI has not increased rates since 1994.<sup>100</sup> VZ-RI argued for a LRIC price floor because it will prevent antitrust violations, and will not result in a price squeeze because a UNE-based CLEC can become reseller or a full facilities-based CLEC. Also, VZ-RI argued that a TELRIC price floor will benefit Cox and will keep retail prices artificially high. VZ-RI also noted that New York has a LRIC price floor.<sup>101</sup> Furthermore, VZ-RI argued that caps on discretionary retail services are unnecessary. VZ-RI stated it should have the ability to geographic deaverage its rates in order to compete on a more level footing with CLECs. Also, VZ-RI noted that under the Settlement, it is required to absorb the first \$1 million of increased costs or revenue decreases due to exogenous events, and that the SQP has tightened standards.<sup>102</sup>

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<sup>99</sup> VZ-RI's Brief, pp. 7-14. At an open meeting on January 23, 2003, the Commission held that the total CLEC market share in Rhode Island in Mr. Silvia's Proprietary Table 1 is public. This information is not proprietary because the public has a significant interest in understanding the basis for the Commission granting VZ-RI additional pricing flexibility.

<sup>100</sup> *Id.*, pp. 14-18.

<sup>101</sup> *Id.*, pp. 18-25.

<sup>102</sup> *Id.*, p. 25-31.

## B. DIVISION

On January 2, 2003, the Division submitted a letter in lieu of a brief. The Division stated that the Settlement is in the public interest. The Division noted the two-year extension for funding of internet access for schools and libraries and the limitation on increases in primary basic residential rates of a \$1 per month, per year for the first two years of the ARP. The Division also pointed out the Settlement's establishment of a LRIC price floor and VZ-RI's concession to reduce its recovery of exogenous event increases by \$1 million.<sup>103</sup>

## C. ATTORNEY GENERAL

On January 10, 2003, the Attorney General submitted a letter. The Attorney General expressed his support for the Settlement, with certain qualifications. The Attorney General stated that he did not favor the prospect of substantial increases for primary basic residential rates, but viewed VZ-RI's voluntary agreement to extend funding for internet access for schools and libraries as a mitigating factor for the increase. Also, the Attorney General stated that the Settlement should extend internet funding through the third year of the plan. Furthermore, the Attorney General urged the Commission to remain vigilant in monitoring competition to ensure that VZ-RI cannot engage in a price squeeze on CLECs by pricing retail services below LRIC.<sup>104</sup>

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<sup>103</sup> Division's letter 1/2/03.

#### D. CONVERSENT

On January 7, 2003, Conversent filed its brief. Conversent indicated that a LRIC price floor will allow VZ-RI to engage in a retail price squeeze on CLECs that purchase UNEs. Also, Conversent argued that the Settlement could allow VZ-RI to engage in improper price discrimination.<sup>105</sup> Conversent argued for the adoption of a TELRIC or UNE based price floor, as adjusted with a resale wholesale discount, and for the Commission to follow the example of the Massachusetts D.T.E. in setting a UNE-based price floor for the following reasons: CLECs purchase UNEs at TELRIC prices, to avoid litigation on a LRIC standard, and to incent VZ-RI not to inflate TELRIC prices in its TELRIC cost studies. In particular, Conversent argued that a TELRIC price floor for business services was appropriate because Cox's network does not reach most business areas and cable companies do not offer telephony on a stand-alone basis any more cheaply than the Incumbent Local Exchange Carrier ("ILEC").<sup>106</sup> Conversent noted that in order for VZ to obtain pricing flexibility in New York, VZ agreed to a \$35 hot cut non-recurring charge and committed to offer the same set of UNEs as are currently offered for the life of the New York plan.<sup>107</sup>

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<sup>104</sup> A.G.'s letter 1/10/03.

<sup>105</sup> Conversent's Brief, pp. 7-9.

<sup>106</sup> Id., pp. 10-15.

### E. COX

On January 7, 2003, Cox filed its brief. At the outset, Cox argued that granting VZ-RI pricing flexibility is premature and that the telecommunications market is unstable. Cox noted that a number of CLECs listed in VZ-RI's competitive profile are bankrupt or no longer providing service. Also, Cox stated its network is not as ubiquitous as VZ-RI's network.<sup>108</sup> Cox argued that resale is unprofitable and cannot put competitive pressure on VZ-RI's retail prices. Also, Cox argued that a LRIC price floor is inadequate for CLECs utilizing UNEs, while a TELRIC price floor with the resale wholesale discount would be administratively easier to enforce. Cox emphasized that a TELRIC price floor would not give Cox an advantage because Cox faces costs not borne by VZ-RI. Furthermore, Cox stated that a TELRIC price floor will incent VZ-RI not to artificially inflate its TELRIC rates. Cox noted that the "only real benefit" of the Settlement is VZ-RI's agreement to provide temporary internet funding for schools and libraries, but Cox maintained that this benefit does not outweigh other policy considerations.<sup>109</sup>

### COMMISSION FINDINGS

An obligation of this Commission is to do what is in the best interest of the ratepayers. The enactment of the Act demonstrated that Congress believed that giving ratepayers choice in telecommunications is

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<sup>107</sup> Id., pp. 15-17.

<sup>108</sup> Cox's Brief, pp. 5-15.

<sup>109</sup> Id., pp. 15-25.

in their best interest. This Commission has stated it will not set policies which give a competitive advantage to one carrier over another.<sup>110</sup> In addition, this Commission has declared that the presumed goal of the Act is to “lift the heavy hand of government regulation from the telecommunications market.”<sup>111</sup> Accordingly, the time has come for this Commission to determine if VZ-RI should have total pricing flexibility for retail rates.

Granting VZ-RI pricing flexibility requires more than a showing that the market is merely open to competition, which is the standard for a successful Section 271 application. There must be a showing that there is sufficient competition to restrain the VZ-RI from exercising market power. Market power is the ability to profitably raise prices above the competitive level for a sustained period of time.<sup>112</sup> In order to determine if a company can exercise market power, market share, supply elasticity, and demand elasticity for the product is examined.<sup>113</sup> Consequently, the product and geographic markets must first be defined.

In defining the product market in which VZ-RI operates, one needs to assess all reasonable substitutes available to ratepayers. To determine if a service is reasonably interchangeable, the alternative product must be compared for purposes of price, use and qualities.<sup>114</sup> In

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<sup>110</sup> Order No. 16032 (issued 12/15/99), p.11.

<sup>111</sup> Id., p. 9.

<sup>112</sup> Ernest Gellhorn & William E. Kovacic, Antitrust Law and Economics in a Nutshell, 4<sup>th</sup> Ed., (1994), p. 94.

<sup>113</sup> Id., pp. 95-97.

<sup>114</sup> Id., pp. 98-103.

regard to telecommunications wireline service, there are not reasonable substitutes at this time. Local telephone service is the near instantaneous two-way exchange of audible information. Wireless telephone service is not as reliable, universal or affordable as landline telephone service. VZ-RI noted that wireless service has not completely displaced wireline service. Thus, the product market for local telecommunications is limited to wireline telephone service for the purposes of this analysis.

The next level of analysis is defining the geographic market for local telecommunications services.<sup>115</sup> It is inherently limited to the boundaries of this Commission's jurisdiction which is the State of Rhode Island. This Commission could geographically delineate separate smaller markets based on whether the area is urban, suburban or rural. This, however, could create administrative difficulties in implementing any retail pricing flexibility. Therefore, this Commission will construe the State of Rhode Island, as a whole, as one geographic market because VZ-RI's retail prices are primarily uniform statewide. The general uniformity of VZ-RI's retail prices among different regions of the state provides some assurance that the prices in less competitive regions of a state will be affected by the prices in more competitive areas of the state.

This leads to the next level of analysis, which is measurement of supply elasticity, demand elasticity, and VZ-RI's market share. In regard

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<sup>115</sup> Id., p. 106.

to demand elasticity, the Division indicated that demand was inelastic for some telecommunications services. Presumably, a reason for defining telephone service as a utility service in Title 39 is because the demand for local telephone service is inelastic.

As for supply elasticity, the quantity and quality of CLECs and/or for resellers in Rhode Island is determinative. VZ-RI's competitive profile for Rhode Island was not persuasive. It listed bankrupt CLECs. It also gave no indication as to the type of services available or number of customers served by the CLECs listed. However, a recent FCC report stated that Rhode Island has 6 CLECs with 10,000 or more access lines, which coincidentally approximates the number of CLEC switches in Rhode Island. In other words, there are presently 6 CLECs offering a competitive alternative to VZ-RI in Rhode Island. With the exception of Cox, whose telephone customers are primarily residential, the vast majority of these CLECs' customers are in the business sector.

Furthermore, resellers cannot place competitive pressure on VZ-RI's retail prices and UNE-P CLECs may be phased out of the competitive market. As a result, in assessing supply elasticity for local telephone service in Rhode Island, it appears that full facilities-based CLEC and UNE loop ("UNE-L") CLECs will provide the most effective competition for VZ-RI. In the business market, the evidence indicates that VZ-RI is competing with a number of full or partially-facilities-based CLECs which have acquired slightly more than one-third of *business* access lines in

Rhode Island. However, in the residential market, VZ-RI is primarily competing with only one CLEC, Cox. Consequently, CLECs have acquired less than fifteen percent of residential access lines in Rhode Island. As the evidence demonstrates, the more the supply elasticity for local telephone service, the greater the CLECs' market share. Thus, market share is an adequate indicator of actual supply elasticity.

Market share is the chief tool for assessing the competitive nature of a market.<sup>116</sup> Ordinarily, market power may be inferred from the market share held by the largest company.<sup>117</sup> In antitrust cases, a market share of one company exceeding 70 to 80 percent supports an inference of market power, while courts have routinely held that market shares of one company below 40 percent fail to support a finding of market power. When market share of a company is between 40 percent and 70 percent, courts tend to find market power is lacking, although exceptions do exist.<sup>118</sup>

In Rhode Island, VZ-RI still has more than 70 percent (79.1 percent) of all local access lines. However, once the access lines are distinguished between residential and business lines, the picture becomes much clearer. VZ-RI still has more than 70 percent (86.1 percent) of all local access residential lines. On the other hand, it has less than 70 percent (66.4 percent) of all local access business lines.

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<sup>116</sup> Id., p. 113.

<sup>117</sup> Id., p. 117.

<sup>118</sup> Id., pp. 117-118.



Consequently, we find that the degree of pricing flexibility given to VZ-RI should be differentiated based on whether it is providing retail residential or retail business services.

In the Rhode Island business market, the VZ-RI market share is below 70 percent. As a result, we find there is sufficient competition to eliminate the need for any price ceilings on VZ-RI's retail business services.

Due to the more than 70 percent market share of VZ-RI in the Rhode Island residential market, however, the Commission finds there is a continuing need for price ceilings on VZ-RI's retail residential services. The Settlement appropriately allows no more than an increase of one dollar per month per year to basic residential exchange rates for the first two years, with any increase in such rates for the third year to be determined at a later date, subject to Commission approval. The one dollar per month per year increase for residential ratepayers is reasonable in light of the fact that VZ-RI's basic residential exchange rates for primary lines have not been increased since 1994.

However, the Commission has also modified the Settlement by establishing price ceilings of five, ten and fifteen percent per year on increases in rates for the various residential discretionary services listed on page 3 of Appendix A to the Settlement. The price ceilings were determined by the magnitude of the amount currently charged to residential ratepayers for the discretionary service, so that the more

expensive a discretionary service, the smaller the allowable price increase. Specifically, the Commission has determined that for residential discretionary services priced at \$5.00 or less per month, the maximum annual rate increase is 15 percent; for services priced at \$5.01 to \$10.00 per month, the maximum annual rate increase is 10 percent; and for services priced at more than \$10 per month, the maximum annual rate increase is 5 percent. These ceilings on price increases for residential discretionary services will limit rate increases for discretionary services to no more than approximately one dollar per month and therefore, mitigate rate shock for the more than 50 percent of VZ-RI's residential customers who subscribe to such services and, would be subject to unlimited increases for such common discretionary services as Call Waiting and Caller I.D.

VZ-RI has emphasized its financial difficulties. The Commission notes, however, that some of its loss of wireline customers may be due to its gains of wireless customers. Furthermore, these retail price ceilings may allow VZ-RI the ability to remain financially strong.

VZ-RI has argued that the lack of any barriers to CLEC entry mitigates the relevance of its Rhode Island market share. Economic theory is persuasive, but actual facts are decisive. The possibility that CLECs may enter the market will give little comfort to ratepayers if their rates increase. Although VZ-RI has complied with Section 271 of the Act and eliminated barriers to entry, there are economic factors that

continue to discourage market entry. VZ-RI has acknowledged that, due to the current state of capital markets, now may be a difficult time to start up a CLEC. Also, facilities- based competition (full or UNE-L) requires a significant investment of capital and time. In addition, UNE-P competition may not survive in the long run as a viable mode of entry depending on FCC and court rulings. Lastly, while resale is an economically affordable mode of entry, it may lack profitability and certainly cannot put downward pressure on VZ-RI's retail prices. In other words, the door is open but no one may come to the party. Accordingly, to protect the ratepayers, actual market share is the chief criteria for determining the appropriate level of pricing flexibility for VZ-RI.

Currently, the residential market is primarily serviced by two full facilities- based carriers, VZ-RI and Cox. A duopoly may not necessarily result in a competitive market and therefore, residential ratepayers need additional protection. For some time, there may be a need to regulate basic primary residential telephone service, especially for those customers who only have POTS. These customers may never be seen by CLECs as particularly attractive and lucrative business prospects. VZ-RI will likely remain for the foreseeable future the universal service provider for the foreseeable future. However, as the CLEC market share grows in the residential market, we expect the need for price ceilings to diminish.

The Commission must not only protect the ratepayers, but also the continuing development of local telephone competition in Rhode Island which, in the long run, will benefit the ratepayers as well. Competition in both the business and residential markets is in its infancy stage. Therefore, there is also a need to establish retail price floors to protect the competitive process. As to the appropriate price floor, at the higher end of the spectrum is a price floor based on TELRIC and a proxy for retail costs based on the resale wholesale discount. At the low end of the spectrum is the antitrust law price floor of average variable cost.<sup>119</sup> Uniquely, VZ-RI faces competition from UNE-based CLECs as well as Cox, which is a full facilities-based CLEC that is not dependent on leasing UNEs at TELRIC rates from VZ-RI. Consequently, setting a price floor based on TELRIC and the resale discount would make it difficult for VZ-RI to compete with Cox. On the other hand, an antitrust price floor could be too low for UNE-based CLECs, such as Conversent, to compete with VZ-RI or Cox.

Although the Act provides the opportunity for a competitor to enter the local telephone exchange market through various modes of entry, it does not guarantee that every mode of entry will be a success. At this initial stage of competition, it is necessary to ensure that CLECs utilizing UNEs can compete successfully. Accordingly, as a compromise, the Commission has adopted the LRIC price floor set forth in the Settlement.

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<sup>119</sup> Id., pp.137-138.

This LRIC price floor will presumably be below TELRIC, but above an antitrust price floor. The Commission anticipates that a LRIC price floor would be approximately 10 percent less than a TELRIC price floor, as indicated by the Division's witness. This type of price floor allows VZ-RI to better compete with its full facilities-based competitor, Cox, while also affording the CLECs utilizing UNEs at least some ability to compete. A LRIC price floor is competitively neutral because it does not significantly advantage one mode of entry over another. In addition, to ensure that the LRIC is properly computed, the Commission expects to suspend a VZ-RI tariff filing for a retail rate below TELRIC so as to trigger a LRIC cost study proceeding. This is consistent with the Division's statement that it would recommend suspension of VZ-RI's initial rate decrease.

Also, a LRIC price floor will prevent VZ-RI from engaging in predatory pricing, which is pricing below its average marginal cost, and will somewhat mitigate the impact of any price squeeze for CLECs utilizing UNEs. Furthermore, the price squeeze concept appears to be of limited applicability in these circumstances. First, a price squeeze could not be applied by VZ-RI to its full facilities-based competitor, Cox, or to resellers. Second, a price squeeze would be ineffective against a CLEC utilizing UNEs to the extent the CLEC can quickly convert to resale. Third, VZ-RI does not control the rates for UNEs; instead, the rates for UNEs are established by the Commission. We will remain vigilant to

ensure that VZ-RI does not engage in a price squeeze on CLECs by pricing retail services below LRIC.

Furthermore, imposing a TELRIC price floor on VZ-RI would not necessarily protect UNE-P or UNE-L CLECs from other competitors. Although Cox advocated for a TELRIC price floor for VZ-RI, Cox would not be required to abide by this price floor.<sup>120</sup> Thus, Cox could under-price the UNE-P or UNE-L CLECs even if the TELRIC price floor was imposed on VZ-RI. Under these circumstances, a TELRIC price floor could prevent customers from enjoying lower prices. Also, we note that even though the New York Public Service Commission did not adopt a TELRIC price floor when it granted pricing flexibility to Verizon in New York, UNE-based CLECs are still effectively competing in New York, and New York remains the most competitive state in the nation. Conversent argued that, because New York's UNE rates are lower than Rhode Island's UNE rates, a TELRIC price floor was unnecessary in New York but still needed in Rhode Island. The Commission notes that, although New York's UNE rates are lower than Rhode Island's UNE rates, the FCC, utilizing the Universal Service Fund ("USF") model, noted that this difference was reasonable.<sup>121</sup>

During the hearings, the issue of geographic deaveraging of retail rates arose. This issue could detrimentally affect both retail ratepayers and the development of local telephone competition in Rhode Island.

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<sup>120</sup> Cox data response dated 12/17/02.

VZ-RI has maintained that the local telecommunications market is competitive statewide. However, there are significant differences between CLEC market share in various VZ-RI wire centers. As a general rule, urban areas have more CLEC market share than in suburban and rural areas. In some wire centers, however, the extent of CLEC market share for residential customers is de minimus. Geographic deaveraging by VZ-RI could exacerbate these differences by allowing VZ-RI to lower prices in competitive areas while raising prices in less competitive areas. In particular, geographic deaveraging could harm residential customers in non-urban areas. The approach advocated by VZ-RI's witness, that retail rates must increase in rural areas in order to attract competitors, is not in the public interest. In promoting the development of competition in the electric energy supply sector, this Commission has emphatically rejected the concept of raising rates to create competition.<sup>122</sup> Competition for the sake of competition has not been adopted in the electric sector and it will not be adopted in telecommunications. The objective is lower rates. Competition is the means to this goal; it is not the goal itself.

Geographic deaveraging is not inherently against the public interest. VZ-RI currently has some rates, such as primary basic residential local exchange rates, that have historically been geographically deaveraged by local calling area based upon the number

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<sup>121</sup> FCC's Approval of VZ-RI's 271 Application, paras. 33-57.

of access lines reached by the customers in that calling area. The Commission is concerned that excessive geographic deaveraging of prices could harm customers in less competitive areas of the state or enable VZ-RI to conduct anti-competitive practices by targeting the customers of a specific CLEC. The Commission will vigorously enforce the anti-discrimination provisions of Title 39 of the Rhode Island General Laws and will continue to be vigilant to any rates that appear to constitute price discrimination. Accordingly, if VZ-RI files tariffs to geographically deaverage retail rates that were uniform statewide or within a particular calling area under the PRSP, VZ-RI must rebut the presumption that the proposed rates do not constitute improper discrimination among similarly situated ratepayers. This presumption may prove particularly difficult to rebut if the proposed geographically deaveraged rates affect residential customers.

The Settlement includes various provisions that require elaboration by the Commission. Paragraphs 5 and 8, and section L all give the Commission the flexibility to re-open the Settlement under appropriate circumstances. In particular, Paragraph 8 expressly states that the Commission retains its statutory authority under Title 39 of Rhode Island General Laws. The Commission's statutory authority is particularly broad. There are numerous scenarios that could cause the Commission to utilize its statutory authority to re-open the Settlement.

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<sup>122</sup> Order No. 16916 (issued 2/15/02), pp. 32-34.



The Commission could re-open the Settlement if it results in unreasonable rates for Rhode Island ratepayers, in significant adverse changes in local competition, or in a significant decrease in VZ-RI's retail service quality. Hopefully, the Commission will not need to exercise its statutory authority to re-open the Settlement.

Also, the Settlement includes an exogenous event provision in Section I. According to Section I, VZ-RI has agreed to absorb the first \$1 million of exogenous events impact prior to increasing rates. Over time, we expect the need for an exogenous event provision to diminish as VZ-RI obtains greater pricing flexibility. However, there was a disagreement between VZ-RI and the Division as to whether a legislative change that made funding of internet access for schools and libraries a pass-through surcharge on ratepayers would constitute an exogenous event under the Settlement. If and when there is a legislative change regarding internet access funding, the Commission will determine if such an occurrence constitutes an exogenous event.

The Settlement promotes the public interest because it provides for VZ-RI to voluntarily fund up to \$4 million of the cost to provide internet access for schools and libraries through December 31, 2004. The development of competition in the local telephone market has reached the stage where the funding for this educational program should not rest exclusively with VZ-RI. The Commission anticipates that the General Assembly will act to ensure there is continued funding for internet access

for schools and libraries. The children of Rhode Island should not be dependent on VZ-RI to continue its voluntary funding of this program. If the General Assembly does not act by the end of the 2003 legislative session, the Commission will initiate a universal service rulemaking proceeding to ensure that funding for internet access will continue.

Also, the Settlement provides for a more stringent SQP. As VZ-RI is afforded pricing flexibility the Commission must ensure that service quality for VZ-RI's ratepayers will not decline, especially for customers with limited alternatives, such as residential ratepayers. We note that VZ-RI's service quality has been steadily improving since the passage of the Act. VZ-RI contends there is no need for a SQP because the competitive market will ensure there is reasonable service quality. However, the Rhode Island local telephone market is neither fully competitive with regard to every customer class nor uniformly competitive among all customer classes. Consequently, an SQP for VZ-RI is a necessary customer safeguard, at least for the near future. The Commission may also consider establishing an SQP for CLECs, as the NYPSC has done.

The Commission is hopeful that a fully functioning competitive market in local telephone service for all customer classes will develop. However, if this does not occur, the Commission will need to evaluate the local telephone market and possibly utilize its statutory authority under Title 39 to intercede. To assist the Commission in obtaining data to

properly monitor the market, the Commission has modified the Settlement to require VZ-RI to file the information contained in Attachment A in Mr. Silvia's direct testimony and Proprietary Table 1 in Mr. Silvia's rebuttal testimony on a quarterly basis, with the first report due on or before May 15, 2003 for the first quarter of 2003. This information contains data regarding CLEC market share by mode of entry, wire center, residential and business access lines and total access lines. This information will also give the Commission early warning signals of any dysfunction in the local market. In addition, the Commission has directed the Division to provide it with annual reports on the status of local telephone competition in Rhode Island. Lastly, the Commission indicated it will establish a rulemaking proceeding to require CLECs to file annual reports with the Commission, providing information regarding the number and type of its customers, its mode of entry and revenues.

For the time being, the Commission must remain vigilant in monitoring the impact on the competitive local telephone market of the additional pricing flexibility afforded to VZ-RI hereby. We hope that in time, the need for price ceilings and price floors will diminish as the competitive local telephone market fully develops. The more competitive this market becomes, the less need there is for regulatory oversight so that at some point, this Commission would only "intervene and interfere

in the natural workings of the competitive market only cautiously and with great circumspection.<sup>123</sup>

VZ-RI may be disappointed that the Commission has not given it more pricing flexibility, particularly in the residential market. However, in 1993 before the FCC, VZ-RI's witness expressed skepticism with regard to AT&T's request for pricing flexibility for residential customers, even though AT&T's residential market share was only about 70%. In comparison, VZ-RI's residential market share is about 85% at present. Under these circumstances, placing price ceilings on VZ-RI's residential rates seems quite reasonable.

The Commission is moving steadily towards a fully developed competitive market with total pricing flexibility for all carriers. This process must be gradual and evolutionary in nature; otherwise, residential ratepayers and even the competitive process could be harmed by rate shock or anti-competitive pricing. The Commission will not guarantee the success of any carrier in the competitive market, but it will act to preserve the competitive process and to protect ratepayers. Ultimately, the existence of actual, fully functioning competition in the local telephone exchange market must precede the implementation of deregulation for VZ-RI.

At an open meeting on January 10, 2003, the Commission reviewed the evidence and approved the Settlement, with certain

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<sup>123</sup> Order No. 16032, (issued 12/15/99), pp. 9-10.

modifications, as just, reasonable, in the public interest, and in the best interest of the ratepayers.

Accordingly, it is

(17417) ORDERED

1. Verizon-Rhode Island's proposed Alternative Regulation Plan filed on July 1, 2002, is hereby denied and dismissed.
2. The Settlement Agreement filed by Verizon-Rhode Island and the Division of Public Utilities and Carriers on December 6, 2002 is approved with the following modifications:
  - a. Residential discretionary services listed on page 3 of Appendix A of the Settlement Agreement will be allowed a maximum annual rate increase of 15 percent if currently priced at \$5.00 or less per month; a maximum annual rate increase of 10 percent if currently priced at \$5.01 to \$10.00 per month; and a maximum annual rate increase of 5 percent if currently priced at \$10.01 or more per month.
  - b. On a quarterly basis, with the First Quarter Report for 2003 due on or before May 15, 2003, Verizon-Rhode Island will file with the Commission the

information contained in Attachment A of Arthur Silvia's direct testimony and the information contained in Proprietary Table 1 of Arthur Silvia's rebuttal testimony filed in this docket.

3. The Division of Public Utilities and Carriers shall provide annual reports to the Commission on the status of competition in the local telephone market in Rhode Island. The first report shall be due on or before January 31, 2004. The Division shall consult with the Commission regarding the type of information to be included in these reports.
4. The Commission will initiate a rulemaking proceeding to require the filing of annual reports by competitive local exchange carriers.
5. Verizon-Rhode Island shall comply with all other terms and conditions imposed by the Settlement Agreement and this Report and Order.

EFFECTIVE AT WARWICK, RHODE ISLAND ON JANUARY 10,  
2003 PURSUANT TO OPEN MEETINGS ON JANUARY 10 AND 23, 2003.  
WRITTEN ORDER ISSUED MARCH 31, 2003.

PUBLIC UTILITIES COMMISSION

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Elia Germani, Chairman

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Kate F. Racine, Commissioner

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Brenda K. Gaynor, Commissioner